

ANALYSIS OF ORIGINAL BILL

Author: Hurt Analyst: Jeani Brent Bill Number: SB 1996
Related Bills: AB 1613, SB 1167 (1998) Telephone: 845-3410 Introduced Date: 02/20/98

Attorney: Doug Bramhall Sponsor:

SUBJECT: Conformity/Education Interest Deduction

SUMMARY

This bill would conform California law to the federal deduction for interest on certain education loans contained in the federal 1997 Taxpayer Relief Act (TRA).

EFFECTIVE DATE

This bill would become effective immediately as a tax levy and apply to taxable years beginning on or after January 1, 1998.

PROGRAM HISTORY/BACKGROUND

The Tax Reform Act of 1986 repealed the deduction for personal interest. Student loan interest generally is treated as personal interest and thus is not allowable as an itemized deduction. Taxpayers, in general, may not deduct education and training expenses. However, a deduction for education expenses is allowed as a trade or business expense if the education or training (1) maintains or improves a skill required in a trade or business currently engaged in by the taxpayer, or (2) meets the express requirements of the taxpayer's employer, or requirements of applicable law or regulations, imposed as a condition of continued employment. Education expenses are not deductible if they relate to certain minimum educational requirements or to education or training that enables a taxpayer to begin working in a new trade or business. In the case of an employee, education expenses (if not reimbursed by the employer) may be claimed as an itemized deduction only if such expenses relate to the employee's current job and only to the extent that the expenses, along with other miscellaneous deductions, exceed 2% of the taxpayer's adjusted gross income (AGI).

SPECIFIC FINDINGS

Existing federal law, under the TRA of 1997, allows certain individuals who have paid interest on qualified education loans to claim an above-the-line deduction for such interest expenses, up to a maximum deduction of \$2,500 for the 2001 taxable year. The maximum deduction is phased in over four years, with a \$1,000

DEPARTMENTS THAT MAY BE AFFECTED:

___ STATE MANDATE

___ GOVERNOR'S APPOINTMENT

Board Position:

___ S ___ O
___ SA ___ OUA
___ N ___ NP
___ NA ___ NAR
___X___ PENDING

Agency Secretary Position:

___ S ___ O
___ SA ___ OUA
___ N ___ NP
___ NA ___ NAR
DEFER TO ___

GOVERNOR'S OFFICE USE

Position Approved ___
Position Disapproved ___
Position Noted ___

Department Director

Gerald H. Goldberg

3/9/98

Agency Secretary

Date

By:

Date:

maximum deduction in 1998, \$1,500 in 1999, \$2,000 in 2000, and \$2,500 in 2001. The maximum deduction amount is not indexed for inflation.

In addition, the deduction is phased out ratably for individual taxpayers with modified AGI of \$40,000-\$55,000 (\$60,000-\$75,000 for joint returns).

The deduction is allowed only with respect to interest paid on a qualified education loan during the first 60 months in which interest payments are required. Months during which the qualified education loan is in deferral or forbearance do not count against the 60-month period. No deduction is allowed to an individual if that individual is claimed as a dependent on another taxpayer's return for the taxable year. A qualified education loan generally is defined as any indebtedness incurred to pay for the qualified higher education expenses of the taxpayer, the taxpayer's spouse, or any dependent of the taxpayer as of the time the indebtedness was incurred in attending (1) post-secondary educational institutions and certain vocational schools defined by reference to section 481 of the Higher Education Act of 1965, or (2) institutions conducting internship or residency programs leading to a degree or certificate from an institution of higher education, a hospital, or a health care facility conducting postgraduate training.

Qualified higher education expenses are defined as the student's cost of attendance as defined in section 472 of the Higher Education Act of 1965 (generally, tuition, fees, room and board, and related expenses), reduced by (1) any amount excluded from gross income for redemption of U.S. savings bonds, (2) any amount distributed from an education IRA and excluded from gross income, and (3) the amount of any scholarship or fellowship grants excludable from gross income, as well as any other tax-free educational benefits, such as employer-provided educational assistance, that is excludable from the employee's gross income.

Existing California law generally is in conformity with the Internal Revenue Code as it read on January 1, 1997, as it relates to educational incentives, which did not allow a deduction for student loan interest.

This bill would allow a deduction for the interest paid by the taxpayer during the taxable year on any qualified education loan up to the following maximum amounts:

<u>Taxable Year</u>	<u>Maximum</u>
1998	\$1,000
1999	\$1,500
2000	\$2,000
2001 or thereafter	\$2,500

Implementation Considerations

Federal law allows the deduction for interest on education loans to be taken in computing adjusted gross income (AGI). Thus, all taxpayers paying this type of interest receive the benefit of the deduction, not only those who itemize deductions. This is known as an above-the-line deduction. As an above-the-line deduction on the federal return, this interest deduction will appear on a significant number of the most simple returns (i.e. the 1040EZ and TELEFILE returns).

The California return begins with federal AGI. Since the bill currently does not contain the federal language that would allow this same above-the-line treatment for state purposes, an adjustment to federal AGI would be required. These adjustments are allowed only as itemized deductions and must be made only on the long Form 540. Thus, those taxpayers who previously were eligible to file the most simple state returns (i.e. 540EZ and TELEFILE returns) and wished to receive the benefit of this deduction would be required to itemize their deductions and file the long form 540 instead of simply claiming an above-the-line deduction, consistent with their federal deduction (thereby avoiding a federal-state difference).

FISCAL IMPACT

Departmental Costs

More taxpayers may file the Form 540, increasing processing costs. This cost, however, is not anticipated to be significant.

Tax Revenue Estimate

Revenue losses from this provision are estimated as follows:

Estimated Revenue Impact of SB 1996 Taxable Years Beginning 1/1/98 Assumed Enactment After 6/30/98		
1998-9	1999-0	2000-01
(\$14)	(\$15)	(\$16)

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this proposal.

Tax Revenue Discussion

The revenue impact for this bill would depend on the amount of qualified interest payments in any given year and the average marginal tax rate applicable to the deduction amounts.

These estimates were derived from information from the California Aid Commission Office on student loans. The vast majority of taxpayers would be former students (rather than parents) with modest incomes. It was projected that of the approximately 1 million students in repayment status, half (500,000) would claim the interest deduction for tax year 1998. Many would not be eligible because of the interest period limitation (first 60 months of payments), AGI tests, home equity financing of loans for which interest is currently deductible, and defaults on loans. It was assumed that the average annual interest payment would be \$600 (one-half of an average annual payment of \$1,200). If a marginal tax rate of 4.5% is applied to these deductions, the impact would be around \$14 million.

BOARD POSITION

Pending.